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In the Supreme Court of the United States

OCTOBER TERM, 1937

No. 528

PACIFIC NATIONAL COMPANY, A CORPORATION, PETITIONER

v.

GALEN H. WELCH, FORMER COLLECTOR OF INTERNAL REVENUE FOR THE SIXTH DISTRICT OF CALIFORNIA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The District Court did not render a written opinion. The opinion of the Circuit Court of Appeals (R. 198) is reported at 91 F. (2d) 590.

JURISDICTION

The judgment of the court below was entered on August 2, 1937 (R. 207). The petition for a writ of certiorari was filed on October 25, 1937. The jurisdiction of this Court is invoked under Section

240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Where a taxpayer filed its return for 1928 in accordance with the method used in its books, reporting sales of certain real estate as completed transactions with all of the consideration as received in that year, may it, upon filing a claim for refund in 1931, change the method and have the profits from the sales computed on the installment basis?

STATUTE AND REGULATIONS INVOLVED

The pertinent portions of the applicable statute and regulations are set forth in the Appendix, *infra*, pp. 15–19.

STATEMENT

The facts as stipulated and as found by the District Court (R. 23–28), so far as material, may be summarized as follows:

The petitioner is a corporation organized under the laws of the State of California, and has its principal office and place of business in Los Angeles, California. The respondent was from April 6, 1926, to June 30, 1933, the duly commissioned and acting Collector of Internal Revenue for the Sixth Collection District of California, and has his office in Los Angeles, California. (R. 23–24.)

The petitioner filed its corporation income tax return for the calendar year 1928 with the re-

spondent on March 14, 1929, in accordance with the basis upon which its books were kept, and paid to the respondent in four installments during 1929 the tax of $10,761.28 shown on the return (R. 24).

In 1927 the petitioner purchased the legal title to certain property. This property was conveyed to the Pacific National Bank in trust as trustee for Trust No. P. T. 46. The petitioner became the sole beneficiary of this trust, and continued so during the entire calendar year 1928. (R. 24, 44.)

In October, 1927, the petitioner employed Frank J. Brick to conduct a sales campaign of subdivision lots included in the holdings of Trust No. P. T. 46, and, with the knowledge, consent, acquiescence and approval of the petitioner, Brick successfully conducted a "high pressure" sales campaign. The petitioner obtained and retained financial benefit and income from the sales made by Brick. (R. 2.)

In its return for 1928 the petitioner reported income from Trust No. P. T. 46 in the amount of $137,007.17, resulting from the sale of subdivision lots. In the determination of this income the sales of the lots were treated as deferred payment sales not on the installment plan, and the obligations of the purchasers were treated as having a fair market value equivalent to their face value. (R. 25.)

The books and records of the trust were kept on the cash receipts and disbursements basis. The

trustee, Pacific National Bank, did not file a fiduciary or other income tax return for the trust for the years 1927 or 1928, nor did its successor trustee do so prior to the institution of the present action. (R. 25–26.)

On February 26, 1931, the petitioner filed a claim for refund of the taxes paid for 1928, setting forth as one of the grounds for the claim that "Profit from sales of real estate in a subdivision trust were erroneously reported as based on closed sales, although the sales were made on the installment basis and proceeds of sales and collections were allocated by the Trustee" (R. 26).

On May 17, 1932, the Commissioner allowed the claim for refund in part upon grounds not in issue here, but rejected that portion of it based upon the ground quoted above (R. 27).

No claim for refund was filed by the petitioner which presented the contention, sought to be raised at the trial, that the obligations of the purchasers of lots from Trust No. P. T. 46 had a fair market value less than the equivalent of their face value (R. 28).

Upon the findings of fact the District Court concluded as a matter of law that the petitioner by its action in filing an income tax return for the calendar year 1928, in which it reported the proceeds from the sale of lots from the subdivision trust upon the deferred payment plan rather than the installment plan, made an election as to the method of reporting the sales, which election be-

came final and binding upon the expiration of the time for filing income tax returns for the calendar year 1928 (R. 30). The judgment in favor of the respondent (R. 32–33) was affirmed by the Circuit Court of Appeals (R. 207).

ARGUMENT

Section 44 (b) of the Revenue Act of 1928, *infra*, p. 15, provides that in the case of a sale or other disposition of real estate, if the initial payments do not exceed 40 per centum of the selling price, the income may, under regulations prescribed by the Commissioner with the approval of the Secretary, be returned on the installment basis; that is, the taxpayer may return as income in any taxable year that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when payment is completed bears to the total contract price.

This provision of the Revenue Act of 1928 is substantially the same as the provision in Section 212 (d) of the Revenue Act of 1926, except that under the 1926 Act a taxpayer was not permitted to use the installment basis if the initial payments exceeded one-fourth of the purchase price. Prior to the Act of 1926 there had been no express statutory provision for the use of the installment plan, the earlier Revenue Acts definitely recognizing only two bases for tax returns—cash and accrual. "The new plan was optional; taxpayers were allowed to elect whether to make returns under the regulations upon the new basis or upon one of the old

bases." *Burnet* v. *S. & L. Bldg. Corp.*, 288 U. S. 406, 413.

1. The present case arises under the Revenue Act of 1928. The petitioner prepared its 1928 income tax return from its books of account upon the basis upon which those books were kept, and reported the sum of $137,007.17 as income resulting from the sale of subdivision lots, in the determination of which the sales were treated as deferred payment sales not on the installment plan, and the obligations of the purchaser were treated as having a fair market value equivalent to their face value. Approximately two years later the petitioner filed a claim for refund in which it sought to change the basis of reporting the sales to the installment plan, and, upon the rejection of the claim, brought the present suit.

As held by this Court in *Burnet* v. *S. & L. Bldg. Corp., supra,* the installment plan of reporting sales is optional and a taxpayer may make an election between that plan and the cash or the accrual basis. Where a taxpayer has the right to elect between two different methods of reporting income, the overwhelming weight of authority is to the effect that when a taxpayer has once made his return in accordance with one of these methods he may not, in the absence of exceptional or unusual circumstances, subsequently change to the other method. *Radiant Glass Co.* v. *Burnet,* 54 F. (2d) 718 (App. D. C.); *Dr. Pepper Bottling Co.* v. *Commissioner,* 69 F. (2d) 768 (C. C. A. 5th);

Lucas v. *St. Louis National Baseball Club,* 42 F. (2d) 984 (C. C. A. 8th), certiorari denied, 282 U. S. 883; *Safety Electric Products Co.* v. *Helvering,* 70 F. (2d) 439 (C. C. A. 9th). The foregoing cases involved the option of affiliated corporations to file consolidated returns or separate returns. The following cases involved the filing of joint or separate returns by husband and wife: *Morris* v. *Commissioner,* 40 F. (2d) 504 (C. C. A. 2d); *Rose* v. *Grant,* 39 F. (2d) 340 (C. C. A. 5th); *Anderson* v. *United States,* 48 F. (2d) 201 (C. C. A. 5th); *Buttolph* v. *Commissioner,* 29 F. (2d) 695 (C. C. A. 7th); *United States* v. *Pettigrew,* 81 F. (2d) 666 (C. C. A. 9th). The uniform ruling is that the same principle applies as to the election to report on the closed transaction or the installment basis. *Strauss* v. *Commissioner,* 33 B. T. A. 855, affirmed *per curiam,* 87 F. (2d) 1018 (C. C. A. 2d); *Rundel* v. *Commissioner,* 21 B. T. A. 1019; *Johnson Realty Trust* v. *Commissioner,* 21 B. T. A. 1333; *Ellis* v. *Commissioner,* 16 B. T. A. 1225; *Viault* v. *Commissioner,* 36 B. T. A. 430. See also *Moran* v. *Commissioner,* 67 F. (2d) 601 (C. C. A. 1st).

The petitioner in the present case apparently admits that this is the general rule. At pages 20–21 of the brief in support of its petition it states:

> It is proper to hold a taxpayer to his original choice between two correct methods, when subsequent events show that he did not choose the more favorable one. It is quite another matter to hold a taxpayer to a

method which was wrong from the very beginning.

It may be, as the petitioner contends, that the courts should not and will not hold a taxpayer bound to the use of a method of reporting income which the courts regard as having been wrong from the beginning and which inherently, that is, aside from some error committed by the taxpayer in the use of the method, does not correctly reflect income. To bring itself within such an exception to the general rule, a taxpayer should, however, make a clear case, particularly where, as here, the Commissioner has accepted the method originally chosen by the taxpayer as one which does correctly reflect the taxpayer's income. The contentions of the petitioner that the basis upon which it originally reported the sales did not correctly reflect its income are not rested upon any of the findings of fact made by the District Court or upon the facts which were stipulated.

Furthermore, the District Court has found as a fact that the petitioner's 1928 income-tax return was prepared upon the same basis upon which the petitioner's books of account were kept, and concluded as a matter of law that the returns met the requirements of the Revenue Act and the Regulations of the Treasury Department (R. 24, 29).

The petitioner argues (Br. 9) that at the end of the taxable year 40 per cent of the contracts were delinquent, and states (Br. 17) that it never actually received a cent from the trust venture and that

it was readily discernible at the end of 1928 that it would not get any income out of the trust. Even if these facts had been established by the proofs, we submit they would not show that the petitioner had used a method of reporting income which would not correctly reflect its income. Perhaps the petitioner placed too high a fair market value upon the obligations of the purchasers received upon the sales, as testified by one of its witnesses (R. 117–118), and therefore has paid a tax which it would not otherwise have had to pay for 1928. Its failure to secure relief on this ground was denied solely because it had not filed a timely claim for refund asserting that contention (R. 28, 29). But at the most that was merely an error which it made in the method used by it, and it is not shown that the method itself was wrong. As to the contracts which were delinquent at the end of 1928, there is an absence in the record of any evidence to establish that at the time there was ground for believing that the delinquencies would not be cured in subsequent years. In any event, however, the fact is immaterial under the closed transaction basis used by the petitioner in its return. The Revenue Acts, furthermore, provide for compensating adjustments and deductions when the contracts are realized upon or when the property sold is retaken by the vendor. See Treasury Regulations 74, Article 354, *infra*, pp. 17–19.

If, as the petitioner says, it received nothing from the trust during 1928, that fact also does not show there was no profit from the sales of the real estate or that such profit was improperly computed. As stated by the court below (R. 199–200), the trust indenture was a security device. It was also a selling and disbursing agency for the petitioner. Under it, the petitioner obligated itself, among other things (R. 74–75), to pay all claims, taxes, liens, assessments, charges and encumbrances affecting title to any part of the property, all costs, charges and expenses of the trust, all costs and expenses of the subdivision, and the principal and interest upon the notes of the petitioner secured by the trust. The trustee was to execute contracts of sale or deeds to purchasers upon the sole written instructions of the petitioner (R. 82), and the entire sales price of each lot was to be paid to the trustee (R. 82) and by it disbursed to discharge the obligations of the petitioner (R. 83–84). There was here the common relation of principal and agent, coupled with the collateral incidents of an ordinary trust. Cf. *Lewis & Co.* v. *Commissioner,* 301 U. S. 385.

We submit that the petitioner has failed to show that the basis upon which it originally reported the sales was one which would not correctly reflect its income, and that the petitioner may not, therefore, urge that it should not be bound by the method which it used on the ground that it was wrong from the very beginning.

2. The petitioner contends (Br. 21) that there can be no election without knowledge of the inconsistent remedies.

It appears from the petitioner's own statement (Br. 19) that its secretary, who made the return for the petitioner, was familiar generally with the installment method of reporting sales of property. The petitioner's contention is that its secretary was guided by the Regulations under the Revenue Act of 1926, which permitted the use of the installment basis only where the initial payments did not exceed 25 per cent of the selling price, and was not aware that the Revenue Act of 1928 had changed the provision to permit the use of the installment basis where the initial payments did not exceed 40 per cent. There is no suggestion by the petitioner that it was not fully advised as to the facts surrounding the sales. When the petitioner prepared its 1928 return, the Revenue Act of 1928 had been in force for more than nine months, and if the petitioner's secretary failed to inform himself of the provisions of that Act, his ignorance should not excuse the petitioner. *Buttolph* v. *Commissioner,* 29 F. (2d) 695, 696 (C. C. A. 7th).

3. The petitioner has cited conflict between the present decision and various decisions of the Circuit Courts of Appeals, the Court of Claims, and the Board of Tax Appeals. We have cited other decisions from those same courts which serve to distinguish the decisions principally relied on by the petitioner and which make it clear that the general

rule is as we contend here and that only in unusual circumstances will this general rule not be applied.

In *Morrow, Becker & Ewing, Inc.* v. *Commissioner,* 57 F. (2d) 1 (C. C. A. 5th), upon which the petitioner relies, the income tax return of the taxpayer, who was engaged in selling real estate on an installment plan, was made a few days after the enactment of the Revenue Act of 1926, which substantially changed the preexisting law, and before the adoption of the Treasury Regulations for carrying out the provisions of the statute as to the basis for determining profits and losses on installment sales of real estate. The court decided that an amendment of the return to make it conform with the Regulations adopted after the return was made was permissible. The court in its opinion in that case stated (pp. 2–3) that the case was not one where, the law being well settled, the taxpayer had elected to keep his books on a certain basis and to make returns accordingly and had afterwards attempted to change the method of accounting or the basis of the return. The court pointed out that if it were such a case it would be proper to hold the taxpayer estopped, as an orderly administration of the revenue laws would otherwise be impossible. Cf. the decision of the same court in *Dr. Pepper Bottling Co.* v. *Commissioner,* 69 F. (2d) 768.

In *Kaplan* v. *United States,* 18 F. Supp. 965, the Court of Claims held, though upon insufficient findings of fact, that the taxpayer, who was upon

a cash receipts basis, had erroneously and mistakenly reported in his return for the taxable year the entire profit which it appeared at the time might ultimately be received but which was not actually received, and that the basis on which he reported the transaction did not clearly reflect his income. While we do not believe that that decision is correct we think it is distinguishable from the present case when read in the light of the opinion of the Court of Claims in *LeBolt & Co.* v. *United States*, 67 C. Cls. 422, where the court said (p. 426):

> The weight of authority is to the effect that where there are two methods of making an income-tax return, either one of which is legal and proper, and the taxpayer has made his return in accordance with one of these methods, then, if the return is accepted and taxes paid accordingly, the taxpayer can not subsequently change to the other method of making a return and thereby become entitled to a refund. But if there is only one legal and proper method of making a return and the taxpayer erroneously makes his return by some other method, then, even, though the return has been accepted and the taxes paid, he may file an amended return correcting the error, and if this return shows an overpayment, he becomes entitled to a refund.

The facts in the present case are different from the facts in the cases relied upon by the petitioner. Here there were no misleading regulations, and

no other unusual circumstances. The law was clear and the petitioner had ample time to inform itself as to its provisions. The return as originally made used a basis which would correctly reflect the petitioner's income. We submit, therefore, that there is no conflict of decisions justifying the issuance of a writ of certiorari in the present case.

CONCLUSION

The decision of the court below is correct. There is no conflict of decisions. The petition for a writ of certiorari should be denied.

Respectfully submitted.

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NOVEMBER, 1937.

APPENDIX

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 44. INSTALLMENT BASIS.

(a) *Dealers in personal property.*—Under regulations prescribed by the Commissioner with the approval of the Secretary, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when payment is completed, bears to the total contract price.

(b) *Sales of realty and casual sales of personalty.*—In the case (1) of a casual sale or other casual disposition of personal property (other than property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year), for a price exceeding $1,000, or (2) of a sale or other disposition of real property, if in either case the initial payments do not exceed 40 per centum of the selling price, the income may, under regulations prescribed by the Commissioner with the approval of the Secretary, be returned on the basis and in the manner above prescribed in this section. As used in this section the term "initial payments" means the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable period in which the sale or other disposition is made.

* * * * *

Treasury Regulations 74:

ART. 352. *Sale of real property involving deferred payments.*—Under section 44 deferred-payment sales of real property fall into two classes when considered with respect to the terms of sale, as follows:

(1) Sales of property on the installment plan, that is, sales in which the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable year in which the sale is made do not exceed 40 per cent of the selling price.

(2) Deferred-payment sales not on the installment plan, that is, sales in which the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable year in which the sale is made exceed 40 per cent of the selling price.

Sales falling within class (1) and class (2) alike include (a) agreements of purchase and sale which contemplate that a conveyance is not to be made at the outset, but only after all or a substantial portion of the selling price has been paid, and (b) sales where there is an immediate transfer of title, the vendor being protected by a mortgage or other lien as to deferred payments.

* * * * *

ART. 353. *Sale of real property on installment plan.*—In transactions included in class (1) in article 352 the vendor may return as income from such transactions in any taxable year that proportion of the installment payments actually received in that year which the total profit realized or to be realized when the property is paid for bears to the total contract price.

If for any reason the purchaser defaults in any of his payments, and the vendor re-

turning income on the installment basis repossesses the property, the entire amount received in installment payments and retained by the vendor, less the sum of the profits previously returned as income and an amount representing proper adjustment for exhaustion, wear and tear, obsolescence, amortization, and depletion of the property while in the hands of the purchaser, will be income of the vendor for the year in which the property is repossessed, and the basis of the property in the hands of the vendor will be the original basis at the time of the installment sale.

If the vendor chooses as a matter of consistent practice to return the income from installment sales on the straight accrual or cash receipts and disbursements basis, such a course is permissible, and the sales will be treated as deferred-payment sales not on the installment plan.

ART. 354. *Deferred-payment sale of real property not on the installment plan.*—In transactions included in class (2) in article 352, the obligations of the purchaser received by the vendor are to be considered as the equivalent of cash to the amount of their fair market value in ascertaining the profit or loss from the transaction.

If the vendor had retained title to the property and the purchaser defaults in any of his payments, and the vendor repossesses the property by agreement or process of law, the difference between (1) the entire amount of the payments actually received on the contract and retained by the vendor and (2) the sum of the profits previously returned as income in connection therewith and an amount representing proper adjustment for exhaustion, wear and tear, obsolescence.

amortization, and depletion of the property while in the hands of the purchaser, will constitute gain or loss, as the case may be, to the vendor for the year in which the property is repossessed, and the basis of the property in the hands of the vendor will be the original basis at the time of the sale. If the vendor had previously transferred title to the purchaser, and the purchaser defaults in any of his payments and the vendor reacquires the property, such repossession shall be regarded as a transfer by the vendor, in exchange for the property, of such of the purchaser's obligations as are applied by the vendor to the purchase or bid price of the property. Such an exchange will be regarded as having resulted in the realization by the vendor of gain or loss, as the case may be, for the year of repossession, measured by the difference between the fair market value of the property and the basis in the hands of the vendor of the obligations of the purchaser (generally, the fair market value thereof which was previously recognized in computing income) which were applied by the vendor to the purchase or bid price of the property. The fair market value of the property shall be presumed to be the amount for which it is bid in by the vendor in the absence of clear and convincing proof to the contrary. If the property so acquired is subsequently sold, the basis for determining gain or loss is the fair market value of the property at the date of acquisition.

If the obligations received by the vendor have no fair market value, the payments in cash or other property having a fair market value shall be applied against and reduce the basis of the property sold, and, if in excess of such basis, shall be taxable to

the extent of the excess. Gain or loss is realized when the obligations are disposed of or satisfied, the amount being the difference between the reduced basis as provided above and the amount realized therefor. Only in rare and extraordinary cases does property have no fair market value.

ART. 355. Gain or loss upon disposition of installment obligations.—If an installment obligation is satisfied at other than its face value or is sold or exchanged, gain or loss results to the extent of the difference between (1) the excess of the face value of the obligation over the amount of income which would be returnable were the obligation satisfied in full and (2) the amount realized upon such disposition.

If an installment obligation is distributed, transmitted, or disposed of otherwise than by sale or exchange, gain or loss results to the extent of the difference between (1) the excess of the face value of the obligation over the amount of income which would be returnable were the obligation satisfied in full and (2) the fair market value of the obligation at the time of such distribution, transmission, or disposition.

* * * * *

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